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Supreme Court, U.S
FILED
DEC 21 1994
OFFICE OF THE CLERK

No. 94-442

In the Supreme Court of the United States

OCTOBER TERM, 1994

IN RE BOSTON POST ROAD LIMITED PARTNERSHIP, DEBTOR

BOSTON POST ROAD LIMITED PARTNERSHIP, PETITIONER

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, AS RECEIVER OF THE NEW CONNECTICUT BANK AND TRUST COMPANY, N.A.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the court of appeals was correct in holding that Sections 1122 and 1129 of the Bankruptcy Code, 11 U.S.C. 1122 and 1129, prohibit a Chapter 11 debtor from proposing a plan of reorganization that places an undersecured deficiency claim arising from a recourse note in a class separate from the claims of the general unsecured creditors in order to gerrymander an affirmative vote on the reorganization plan and "cram down" the plan over the objections of the undersecured creditor.

2. Whether the court of appeals was correct in holding that the security deposit claims of residential lessees in this case, whose leases had been assumed by the bankruptcy estate, did not comprise an "impaired" class within the meaning of Section 1124 of the Bankruptcy Code, 11 U.S.C. 1124.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 36-64) is reported at 21 F.3d 477. The opinion of the district court (Pet. App. 17-35) is reported at 154 B.R. 617. The opinion of the bankruptcy court (Pet. App. 1-16) is reported at 145 B.R. 745.

JURISDICTION

The judgment of the court of appeals was entered on March 30, 1994. A petition for rehearing was denied on June 14, 1994 (Pet. App. 101-102). The petition for a writ of certiorari was filed on September 12, 1994. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner, a Connecticut limited partnership, was formed in 1984 to acquire, own, and manage a residential and office complex located in Waterford, Connecticut (the Property). Pet. App. 2-3, 37-38. In March 1988, petitioner mortgaged the Property to the Connecticut Bank and Trust Company, N.A. (the Bank), to secure a loan of approximately $1.6 million. *Id.* at 2-3, 38. Petitioner subsequently defaulted on the mortgage payments and, on July 20, 1990, the Bank commenced foreclosure proceedings in Connecticut Superior Court. *Id.* at 3, 38. After the Bank itself failed in January 1991, the Federal Deposit Insurance Corporation (FDIC), as receiver, was substituted as the plaintiff in the foreclosure action. *Id.* at 3, 38. On August 1, 1991, the Superior Court entered a judgment of strict foreclosure in favor of the FDIC. *Id.* at 3, 38-39. October 28, 1991, was set as petitioner's last day to redeem the Property. *Ibid.* On that date, petitioner filed for protection in the United States Bankruptcy Court for the District of Connecticut under Chapter 11 of the Bankruptcy Code, 11 U.S.C. 1100 *et seq.*, thereby staying foreclosure. *Id.* at 3, 39.

2. Petitioner filed its Second Amended Plan of Reorganization (Plan) on June 18, 1992. Under the Plan, petitioner proposed seven classes of creditors: Class 1—unsecured claims of residential tenants to their security

deposits; Class 2—the FDIC's secured claim; Class 3—secured claims of residential tenants whose security deposits are held by petitioner in interest-bearing bank accounts; Class 4—unsecured claims of general trade creditors; Class 5—the FDIC's unsecured deficiency claim; Class 6—partnership interests of the limited partner; and Class 7—partnership interests of the general partner. Pet. App. 39-40. The Plan proposed to pay the tenants' security deposit claims in full, with interest at 8 percent per annum (which represented a "bonus" of 2.75 percent over the then-statutorily mandated 5.25 percent rate), and to pay the general unsecured trade creditors (whose claims total about $5000) in full, without interest, over a six-year period. *Id.* at 3-5, 40-41. With respect to the FDIC's claims, the Plan was less generous. Petitioner proposed to pay the FDIC's $1,445,000 secured claim over 15 years, with negative amortization and a balloon payment at the end of the fifteenth year, and to pay the FDIC's $500,000 unsecured deficiency claim over 15 years or until the Property was sold (whichever came first), without interest. *Id.* at 4, 40.[1] Class 1 turned out to be nonexistent; Classes 2 and 5 (*i.e.*, the FDIC) objected to and voted to reject the Plan; and Classes 3, 4, 6, and 7 voted to accept the Plan. *Id.* at 5, 41.

3. At the confirmation hearing on August 12, 1992, petitioner contended that, based on the affirmative votes of Classes 3 (the residential security deposit holders)

[1] The parties agreed that the value of the Property was $1,445,000. Because the FDIC chose, under 11 U.S.C. 1111(b)(2), to have its deficiency claim treated as a separate unsecured claim, the aggregate $1,945,000 debt owed to the FDIC is made up of a secured claim for $1,445,000 and an unsecured deficiency claim for the remaining $500,000. Pet. App. 4 n.3, 5, 40 n.1, 44.

and 4 (the general unsecured trade creditors), both of which petitioner claimed were "impaired" classes within the meaning of Section 1124 of the Bankruptcy Code, 11 U.S.C. 1124, petitioner was entitled to cram down[2] the Plan over the FDIC's objections.

The bankruptcy court denied confirmation. It held that the fact that each residential tenant would receive "bonus" interest under the Plan did not render the tenants' claims "impaired," because the payment of additional interest would not alter the tenants' preexisting rights to the return of their security deposits with 5.25 percent accrued interest upon vacating the property. In the court's view, "to provide for additional interest to be paid on tenants' security deposits in order to create an *impaired* class is to turn the doctrine of impairment * * * on its head and is totally impermissible. If [petitioner] were correct, * * * any time a plan proponent needed an impaired class for a favorable vote, the debtor would simply add $1.00 to such class members' claims." Pet. App. 9-10 (emphasis added).

Turning next to the proposed separation of the FDIC's deficiency claim from the claims of the general unsecured trade creditors, the court adopted the uniformly held view that the Code prohibits a debtor from "classifying similar claims differently in order to gerrymander an affirmative vote in favor of a reorganization plan." *Id.* at 11. Finding no legal or business

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[2] "Cram down" refers to a procedure allowed by Section 1129(b) of the Bankruptcy Code, 11 U.S.C. 1129(b), whereby a plan of reorganization may be confirmed despite the plan's rejection by one or more classes of creditors, so long as various requirements are met, including the requirement that at least one class of impaired creditors has voted to accept the plan.

rationale that justified placing the FDIC's undersecured claim in a separate class, the court held that the FDIC should have been included in Class 4 with the other unsecured creditors, which would have resulted in a negative vote by that class given the size of the FDIC's claim. *Id.* at 10-15.

The district court agreed with the reasoning of the bankruptcy court[3] and affirmed the order denying confirmation. *Id.* at 17-35.

4. The court of appeals affirmed. Pet. App. 36-64. The court concluded, as had the bankruptcy and district courts before it, that petitioner should have included the FDIC's under-secured claim in the class of general unsecured claims, which would have prevented that class from voting in favor of the Plan. *Id.* at 63-64. The court of appeals also shared those courts' skepticism with respect to petitioner's argument that the residential tenants would be "impaired" within the meaning of Section 1124 by the promise of additional interest, but found it unnecessary to decide that issue. Pet. App. 59-60. As the court explained, because petitioner had assumed the tenants' leases, "the leases ha[d] no provable claim against the bankruptcy estate," and instead constituted post-petition priority administrative claims, which carry no right to vote on a plan of reorganization. *Id.* at 61-62. The vote of the residential tenants in favor of the Plan could not, therefore, justify a "cram down" over the objections of the FDIC. *Id.* 62-63.

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[3] See Pet. App. 34 ("[T]he fact that the value of a claim is enhanced by a plan has no bearing on whether the class of claims is impaired, absent a finding that the rights of the class are altered as well."); *id.* at 31 ("[T]he court agrees with the Bankruptcy Court that the only reason for [petitioner] to segregate the substantially similar unsecured claims is 'to fabricate an accepting class under 11 U.S.C. § 1129(a)(10) in order to effectuate a cramdown.'").

ARGUMENT

The court of appeals correctly applied settled law in deciding that petitioner's Plan could not be confirmed because there was no assent of an impaired non-insider class of creditors. Its decision does not conflict with any decision of this Court or of any other court of appeals.

1. Petitioner argues (Pet. 17-21) that the court of appeals' decision in this case conflicts with the Seventh Circuit's decision in *In re Woodbrook Assocs.*, 19 F.3d 312, 318 (1994). In *Woodbrook*, the Seventh Circuit held that an unsecured claim arising out of a nonrecourse obligation was substantially different from other unsecured claims and therefore could be placed in a separate class. The factual circumstances of this case, however, distinguish it from *Woodbrook*, as well as from most other cases that have dealt with the issue of whether the separate classification of undersecured claims is permissible under Chapter 11.

The courts of appeals have uniformly concluded that, although Section 1122(a) of the Bankruptcy Code, 11 U.S.C. 1122(a), does not expressly prohibit the separate classification of similar claims, a plan proponent may not separately classify similar claims for the sole purpose of manipulating the plan confirmation voting process.[4]

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[4] See *In re Greystone III Joint Venture*, 995 F.2d 1274, 1279 (5th Cir. 1991) (setting forth the "one clear rule" regarding claims classification by debtors: "[T]hou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan."), cert. denied, 113 S. Ct. 72 (1992); see also *John Hancock Mut. Life Ins. Co.* v. *Route 37 Business Park Assocs.*, 987 F.2d 154, 159 (3d Cir. 1993); *In re Lumber Exch. Bldg. Ltd. Partnership*, 968 F.2d 647, 649 (8th Cir. 1992); *In re Bryson Properties, XVIII*, 961 F.2d 496, 502 (4th Cir.), cert. denied, 113 S. Ct. 191 (1992); *In re Holywell Corp.*, 913 F.2d 873, 880 (11th Cir. 1990); *In re U.S. Truck Co.*, 800 F.2d 581, 586 (6th Cir. 1986); cf.

The courts agree, however, that a claim may be placed in a class separate from claims similar to it when legitimate reasons support the separate classification.

In *Woodbrook*, the Seventh Circuit held that a Section 1111(b) undersecured deficiency claim that arises from a nonrecourse loan, is "not substantially similar" to the claims of other unsecured creditors. 19 F.3d at 318. The disparity, the court explained, "stem[s] from the most obvious difference between the two claims: a general unsecured claim exists in all chapters of the [Bankruptcy] Code, while a § 1111(b) claim exists only as long as the case remains in Chapter 11 and, once converted to a Chapter 7 case, recovery is limited to its collateral." *Ibid.*[5]

Granada Wines, Inc. v. *New England Teamsters & Trucking Indus. Pension Fund*, 748 F.2d 42, 46-47 (1st Cir. 1984) (stating that all creditors of equal rank should be grouped in the same class). Although the court in *Woodbrook* noted that it may be difficult in practice to determine whether a debtor has placed claims in separate classes for a bad purpose, it acknowledged that "limits [on the debtor's discretion to classify claims and interests] are necessary to offset a debtor's incentive to manipulate a classification scheme and ensure the affirmative vote of at least one impaired class," 19 F.3d at 318.

[5] The court in *Woodbrook* also noted that an undersecured creditor may have different interests in bankruptcy from those of a general unsecured creditor. 19 F.3d at 318. It suggested that an undersecured creditor "may vote its large deficiency claim to defeat any plan, obtain relief from the automatic stay and foreclose, while the general unsecured claimant has a strong incentive to vote to accept the plan because it may receive nothing from liquidating the debtor if the automatic stay is lifted." *Ibid.* The majority of circuits have held that those differing incentives do not support separate classification. See, *e.g.*, *John Hancock Mutual Life Ins. Co.*, 987 F.2d at 161 ("Absent bad faith or illegality, the [Bankruptcy] Code is not concerned with a claim holder's reason for voting one way or the other, and undoubtedly

As the Seventh Circuit recognized, see *Woodbrook*, 19 F.3d at 318, all of the other courts of appeals that have considered the matter have ruled to the contrary, holding that the fact that a deficiency claim has been created from a nonrecourse loan by action of law under Chapter 11 does not mean that such a claim, once created, should be treated differently under Chapter 11 from other unsecured claims. See, *e.g.*, *In re Greystone III Joint Venture*, 995 F.2d 1274, 1278 (5th Cir. 1991), cert. denied, 113 S. Ct. 72 (1992); *John Hancock Mut. Life Ins. Co.* v. *Route 37 Business Park Assocs.*, 987 F.2d 154, 159 (3d Cir. 1993); *In re Lumber Exch. Bldg. Ltd. Partnership*, 968 F.2d 647, 649 (8th Cir. 1992); *In re Bryson Properties, XVIII*, 961 F.2d 496, 502 (4th Cir.), cert. denied, 113 S. Ct. 191 (1992). To the extent that *Woodbrook* has created a circuit conflict on the issue, that conflict cannot be resolved in this case. Here, the FDIC's unsecured claims arose not from Section 1111(b) of the Bankruptcy Code, but instead as a matter of contract, through petitioner's *recourse* obligation. Because the deficiency claim would be treated under state law as an ordinary unsecured debt, the FDIC would not be limited to its collateral as a source of recovery if this case were converted to Chapter 7. Accordingly, the "significant disparities" between the undersecured creditor and general unsecured creditors that the

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most claim holders vote in accordance with their overall economic interests as they see them.") (citation omitted); *Greystone III*, 995 F.2d at 1279-1280. Although the Seventh Circuit found the incentives-based distinction "worthy of careful study," it reserved judgment on whether the distinction justifies separate classification of undersecured and unsecured claims. See *Woodbrook*, 19 F.3d at 318.

Seventh Circuit found dispositive in *Woodbrook* do not exist here.

2. Petitioner also contests (Pet. 21-28) the lower courts' determination that the residential tenants' security deposit claims do not comprise an "impaired" class. In petitioner's view, because the residential security deposit holders were to receive "bonus" interest under the Plan, the Plan "impaired" the claims of those security deposit holders. That argument is without merit.

The court of appeals correctly determined that because petitioner neither assumed nor rejected the tenants' leases, the leases were assumed by petitioner as a matter of law, and the tenants therefore have no pre-petition claims against the bankruptcy estate with respect to their security deposits. See *Greystone III*, 995 F.2d at 1281; *In re Whitcomb & Keller Mortgage Co.*, 715 F.2d 375, 378-379 (7th Cir. 1983); *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1352 (9th Cir. 1983). The tenants' rights under their leases constitute post-petition administrative claims under Section 503(b)(1)(A) of the Bankruptcy Code, 11 U.S.C. 503(b)(1)(A), the holders of which are not entitled to vote on a plan of reorganization. See *Greystone III*, 995 F.2d at 1281; *In re Distrigas Corp.*, 66 B.R. 382, 385-386 (Bankr. D. Mass. 1986).[6]

[6] Petitioner contends (Pet. 22), without elaboration, that the issue respecting the proper classification of security deposit claimants is "governed" by *Bryson Properties, XVIII*, *supra*, and *In re River Village Assocs.*, 161 B.R. 127 (Bankr. E.D. Pa. 1993). *Bryson Properties* provides petitioner no support. That opinion merely states that a class comprised of tenant security deposit claims was one of several classes proposed by a reorganization plan. 961 F.2d at 499. Because the debtor did not contend that the class of security deposit claims was impaired, the court had no occasion

In addition, the bankruptcy and district courts correctly held that, even if the tenants' security deposit claims had given them a voice in the confirmation process, the proposal by petitioner to benefit the tenants by providing them with additional interest on their deposits would not render their claims "impaired." Under Section 1124(1) of the Code, 11 U.S.C. 1124(1), a class of claims is not impaired if the plan "leaves unaltered the legal, equitable, and contractual rights to which such claim * * * entitles the holder." The proposal to pay the tenants interest on their security deposits at a rate greater than that required by law may vest a new right in the tenants, but it does so without altering their preexisting rights to a return of their security deposits with statutory interest.

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to address whether it was a proper class. Although the court in *River Village Assocs.* affirmed the voting rights of security deposit claimants whose claims (unlike those of the tenants here) would have been adversely affected by the proposed reorganization plan, it rejected the undersecured creditor's objection to that classification primarily on the ground that the undersecured creditor had failed to raise a timely objection to it. 161 B.R. at 132.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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